DEPARTMENT OF COMMERCE
Washington, D.C. 20230

ECONOMICS AND STATISTICS ADMINISTRATION
Office of the Under Secretary

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March 26, 2002
(as prepared for delivery)

DISCRETIONARY FISCAL POLICY: MYTH OR REALITY?

Has discretionary fiscal policy returned? After so many years of high budget deficits and little consideration of active counter-cyclical fiscal policy, it is interesting that this question is again being asked. I suppose that is because of its recent success, but I will come back to that thought.

Over the past two decades, conventional wisdom has evolved toward the belief that monetary policy should be the prime medicine for fighting economic cycles. The automatic stabilizers within our fiscal system serve as counter-cyclical mechanisms, but most economists believe that discretionary fiscal policy should be used to deal with long-term issues – equity and efficiency issues affecting economic growth. What is the appropriate share of taxes that should be paid by different income groups? How do we provide the "right" government services efficiently for the American people?

The reasons for this evolution in thinking are several. Implementation lags are shorter for monetary policy than for fiscal policy. Monetary policy is more flexible, in case a reversal of course is required. Tax cuts – the usual form of stimulative discretionary fiscal policy – are much easier to achieve than tax increases. Indeed, no tax increases or spending cuts were proposed in early 2000 when the economy was roaring, but monetary policy did move to reduce the frothiness of the expansion.

Because of this thinking, discretionary counter-cyclical policy has been on the shelf for some time. In 1992, for example, then-President Bush proposed legislation to speed recovery from the 1990-91 recession. It was rejected. Budget deficits "as far as the eye can see" were the reason verbalized, but the underlying tension about the appropriate use of fiscal policy also discouraged passage.

As John Taylor writes in his Summer 2000 Journal of Economic Perspectives article on discretionary fiscal policy, recent studies of the U.S. and other countries revealed not just implementation lags but impact lags as long and uncertain as monetary policy. In some countries, as he points out, fiscal consolidation even seemed to have the wrong sign. In Japan's case, repeated spending programs had little stimulative effect.

Because the President's package became law so quickly last year and because another stimulus package passed just this month, we now ask ourselves whether we have been too pessimistic about timely fiscal action. Have we ignored discretionary fiscal policy for too long? Is appropriate discretionary fiscal policy a myth or can it be a reality? Economists and policymakers can and should take time periodically to think about such issues.

Most of the rest of the country worries about how much of their paychecks the government is taking. And will the reality of fiscal policy enacted by this administration and Congress leave them enough money for school clothes for the kids or dinner out on a fairly regular basis?

But we need to re-examine whether beliefs that discretionary fiscal policy is ineffective is another of those Washington myths.

For example, President Bush signed the tax cut bill on June 7 last year. At the time the myth, or conventional wisdom, was that Americans would not respond to the rebates.

I am convinced that those rebate checks helped soften the recession. In the darkest days after September 11, you and I – none of us – knew how consumers would react. Streets were empty, the markets closed, the economy at a standstill.

The reality is that those checks plus the increased take home pay from reduced withholding contributed to solid consumer spending in the fourth quarter of some six percent. I acknowledge that a number of other factors acted to put money in American wallets.

Lower energy costs accounted for as much of a boost to disposable income as did the tax cuts. Monetary policy too gave consumers a boost via lower financing costs. Government spending, since September 11th, contributed seven-tenths of a percentage point to fourth quarter growth.

Doubtless without the President's tax cut the recession would have been deeper and longer. The Bush tax cut was designed in 2000 –recognizing the role tax policy plays in generating long-term growth. But the fact is that timing and the direction of the economy by Spring 2001 necessitated a plan to shore up near-term growth, acting as an insurance policy against further economic weakening.

It did just that – injecting an estimated $57 billion into the economy in the second half of 2001 and $69 billion in 2002 –boosting GDP growth 1.2 percentage points in the second half of 2001 and a half percentage point in 2002.

An historical perspective is useful. Relative to GDP, the 2001 tax cut is comparable to those enacted during the 1970s but is small compared to the Reagan tax cut. The Joint Committee on Taxation estimated that the Bush tax cut would reduce government revenue $56 billion, on average, in its first two years, which would be equivalent to about one half percentage point of GDP. The five major tax bills during the 1970s reduced revenue a similar one half percentage point, relative to GDP, in their first two years. In contrast, the 1981 Reagan tax cut reduced revenue nearly two percentage points in the first two years, nearly four times greater than the projected effect of the Bush tax cut.

Fiscal policy, of course, whether discretionary or not, does have a stimulative effect –– just as it did in the early 1980s. Remember the days of stagflation and 20 percent interest rates? President Reagan outlined <u>his</u> tax cut to emphasize his philosophy about the role and size of the federal government. But as the economy turned downward again in the fall of 1981, the tax cuts became integral to the strong rebound in 1983-84. Initially, monetary policy worked against fiscal policy, but the Federal Reserve began easing in July 1982. As both fiscal and monetary policy began working in tandem, the economy came roaring back in 1983. Housing and auto sales led the boom.

Many factors accounted for the 1980s recovery. But it is difficult to imagine such a strong recovery without President Reagan's tax cuts.

I've learned in my 10 months in Washington that fiscal policymakers want to respond to economic downturns. They want to help and take credit for helping. Indeed, another of those myths is that fiscal policy <u>always</u> carries the burden of a long time lag.

Responding to September 11, the Federal Reserve Board acted quickly -- that very day -- to provide liquidity and calm fears. As nimble as monetary policy can be, fiscal policy development is awkward. This time was different because of the drama of the events. Immediately, the Congress went along with the President's request for $40 billion in emergency supplemental appropriations.

In early October, President Bush called for further stimulus that would have included:

- Reduced taxes for low- and moderate-income households;
- Accelerating the tax cuts passed in 2001;
- Allowing partial expensing on business capital equipment;
- Eliminating the corporate alternative minimum tax; and
- Extending unemployment benefits.

Five months later, on March 9, President Bush signed an economic security bill that included the expensing provision and extended unemployment benefits.

The myth around town, and no doubt in this room, is that the package is a day late and a dollar short.

The truth is that fiscal policy is an inexact science with 535 people championing their different agendas. Fiscal policy requires a mastery of the art of the achievable.

The President and the country might well have preferred his autumn legislation in its entirety. Unfortunately, 60 members of the Senate did not agree.

What we achieved -- through a sometimes unwieldy process -- is growth insurance and, frankly, it will help those for whom the recession was the most severe – Americans who lost their jobs.

Today we have more than two-thirds as many people who have been unemployed for at least six months than in the Fall of 2000. And the unemployment benefits extension is immediate. States can deliver the enhanced benefits right away, and those folks will spend it right away.

In most postwar business cycles, turns in household spending have led business investment. Peaks and troughs in household investment spending have taken place <u>before</u> those in business investment. Consumers have tended to be more sensitive to credit conditions than business managers.

This cycle was different. Business investment weakened much sooner and more significantly than one would have expected, given the seeming lack of credit pressures and the favorable trend in household spending. Just as business investment helped drive the previous expansion, business investment was a prime mover in the current downturn. The stimulus bill's provision on expensing will help.

We witnessed five months of substantial debate over what should be included in a stimulus package – the shape of fiscal policy. The end result was true to President Bush's guidance. It should be, and is, pro-growth – it should enhance incentives to work, invest, take risks, and increase productivity.

And it should address critical short-term needs. As Council of Economic Advisers Chairman Glenn Hubbard has said, "The President recognized this early on, incorporating tax relief for low-income families and targeted extensions of assistance for displaced workers. This addresses their needs and provides some demand-side insurance for businesses."

Clearly a variety of forces are affecting the beginning of this recovery.

There are valid reasons for optimism. Employment rose 66,000 in February, the first increase in seven months. Industrial production has posted consecutive monthly gains for the first time since August and September of 2000. Shipments of non-defense capital goods have begun to turn up, suggesting that the weakness in business investment is coming to an end. Furthermore, business inventories have started to expand again, following deep cuts in 2001, and this shift is likely to boost first-quarter GDP substantially.

CEOs may not share economists' optimism. Commerce Secretary Evans speaks to business leaders daily and he reports that they are not upbeat.

The dichotomy between the outlooks of economists and business leaders is striking. It merits the serious attention of Washington policymakers, because it could have important implications for the rate of recovery in hiring and investment over the next year. In short, CEO pessimism could portend another "jobless recovery."

Again and again, following the 10 recessions since World War II, unemployment has persisted as a problem, even while other measures made it clear the economy was squarely in the midst of recovery. In fact, unemployment continued to worsen for a full nine to 15 months *after* the shallow recessions of 1969-70 and 1990-91 actually ended.

While recently released data indicated a dip in unemployment to 5.5 percent, and the trend line on initial jobless claims has been positive since year-end, Washington ignores this lingering uncertainty in the employment picture at its peril.

Two factors get primary credit for keeping the 2001 recession relatively shallow: continuing gains in worker productivity and unexpectedly strong household spending. These are positive for the economy overall, but not necessarily for the jobs outlook.

Higher productivity is a positive for the U.S. economy overall. It builds long-term competitiveness and enhances our capacity for higher future growth without inflation. But, as we focus on the employment side of the economy, we must bear in mind that a side effect of productivity gains is their constraining effect on new hiring. We must add other ingredients to the recovery environment to spur job creation.

Consumer spending has proven to be a major stabilizing force. Again, the well-timed tax cut President Bush and Congress put into effect last year, along with the zero-percent financing for automobiles, were driving forces behind strong consumer spending.

But by this point, households have adjusted to new withholding amounts, and household debt is on the rise. If the job picture fails to brighten, confidence could be dampened, slowing consumer spending in the months ahead.

As Chairman Greenspan said recently, “Even if the economy is on the road to recovery, the unemployment rate may resume its increase for a time, and a soft labor market could (dampen) consumer spending.” Job creation, in this environment, is paramount. It is the President’s top domestic priority.

Making good fiscal and monetary policy decisions, making legislative decisions about the direction of energy and trade policy, not to mention private sector investment and employment decisions – depend on having accurate and timely data on the economy. We can and will better reflect the reality of the economy.

Recent experience underlines the need for two particular initiatives in President Bush’s budget for 2003. We need to provide quarterly data on many service and e-business industry sectors and to enhance and accelerate the release of trade data. If these initiatives had been in place in the last couple of years, we would have had a clearer picture sooner of the swings in the national economy. The Commerce Department, through the President’s budget request, will do just that through statistical quality improvement.

As you know, when BEA released its first estimate for fourth quarter GDP growth in January of + 0.2 percent, many were surprised that it was a positive number and predicted a downward revision in February. Instead, BEA revised its estimate up to 1.4 percent in February. Five tenths of that upward revision came from incorporating the information on December trade numbers that were released in mid-February. With our new initiative, the trade numbers for all three months of the quarter would be published before the first GDP estimate. If the December trade numbers had been available before the January GDP release, not only would BEA have given us an estimate of 0.7 percent growth, but people would have been more confident that the final number would remain above zero. As a result, discussions about the state of the economy would have been better informed in late January and into February.

The last couple of years have also highlighted the need for the proposed quarterly survey on service industry output. Last summer, after annual Census data on the software industry became available, BEA made a $50 billion downward revision to its estimate of software investment in 2000. We know that a number of other major service industries are also cyclically sensitive. As we consider the NBER peak of March 2001 and BEA's estimate that GDP advanced by a scant 0.3 percent rate in the following quarter, it is clear how helpful timely, quarterly measures of services output would be.

Lacking the kind of output measures available for goods and construction industries, the BEA must now estimate the output of many service industries with BLS employment and wage data. And these BLS data themselves are subject to significant revision, particularly at cyclical turning points in the economy.

In launching the proposed quarterly survey of services industries, the Census Bureau has coordinated its efforts with the BEA, BLS, and the Federal Reserve. They have chosen an initial set of industries to allow the most 'bang for the buck' in improving GDP estimates based on the industry's size, volatility, and absence of alternative source data. For an annual cost of $3 million, we can obtain quarterly data on services industries with $2 trillion in annual sales. Over the coming years, we hope to extend coverage to additional industries—further strengthening our estimates of services industries and allowing higher quality estimates of the economy.

NABE has been at the forefront of advocating and supporting our effort to enhance these data. Thank you. Keep up the good work.

I am confident that these more accurate economic measures will help policymakers, business leaders and all Americans make better decisions.

In closing, the lesson we can take from successful Bush fiscal policy is <u>not</u> that we have permanently changed fiscal policy decision-making, although coupled with fortuitous timing and other policy factors, fiscal policy did have tangible and beneficial effects over the past year. Nor do I propose a return to fiscal fine-tuning; automatic stabilizers serve the appropriate cyclical role for fiscal policy in most cases. I continue to believe that the most powerful and flexible tool in economists' counter-cyclical toolbox is monetary policy. The improvements in its implementation over the last two decades, coupled with even-better information flows, have helped to reduce economic volatility, which has clearly been a plus for Americans.

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